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FISCAL IMPACT STATEMENT

LS 6502
BILL NUMBER: HB 1455

NOTE PREPARED: Dec 27, 2002
BILL AMENDED:

SUBJECT: Tax Deduction for Federal Retirement Benefits.

FIRST AUTHOR: Rep. Welch
FIRST SPONSOR:

BILL STATUS: As Introduced

FUNDS AFFECTED: **X** **GENERAL**
X **DEDICATED**
FEDERAL

IMPACT: State & Local

Summary of Legislation: The bill provides an Adjusted Gross Income (AGI) Tax deduction for part of a federal government pension (including a military pension) received by an individual or an individual's surviving spouse, in an amount that does not exceed the difference between: (1) the maximum benefits payable under Social Security that could have been excluded from federal gross income for the year; and (2) the Social Security benefits actually received by the taxpayer during the year. The bill also provides that a taxpayer may not claim both this deduction and the existing military service deduction or federal civil service deduction.

Effective Date: July 1, 2003.

Explanation of State Expenditures: The Department of State Revenue (DOR) would incur some administrative expenses relating to the revision of tax forms, instructions, and computer programs to incorporate the new military and civil service pension deduction. These expenses presumably could be absorbed given the DOR's existing budget and resources.

Explanation of State Revenues: If all civil service and military pension income not already claimed under current deductions is deducted under the provisions of the bill, it could potentially reduce revenue from the Adjusted Gross Income (AGI) Tax by as much as $32.8 M in FY 2005. However, the actual fiscal impact of the bill could potentially be reduced to the extent that taxpayers (or their spouses) receive Social Security benefits. In addition, the fiscal impact could be further reduced to the extent that taxpayers' pension income exceeds the maximum amount of benefits payable under Social Security that may be excluded from federal gross income.

Background: This bill provides an Individual AGI Tax deduction for recipients of federal civil service pensions and military pensions beginning in tax year 2004. The bill permits a taxpayer to deduct the amount of civil service or military pension benefits included in the taxpayer's federal AGI. However, the deduction may not exceed: (1) the amount of civil service or military benefits received by the taxpayer that would have been tax-exempt if they had been treated as Social Security benefits; minus (2) the amount of Social Security benefits actually received by the taxpayer that are tax-exempt. The bill prohibits a taxpayer from claiming both the deduction established under the bill *and* the existing military service deduction or federal civil service annuity deduction.

The typical maximum excludable Social Security benefit for taxpayers who receive income from military or civil service pensions is indeterminable. In addition, no data is available which indicates the Social Security benefit typically obtained by individuals who receive income from military or civil service pensions. As a result, the estimated impact assumes that <u>all</u> income from military and civil service pensions would be deducted under the bill. The estimate also nets out the cost of the current $2,000 deductions for civil service annuities and military retirement benefits

Civil Service Annuities: Under current statute, taxpayers may deduct up to $2,000 in civil service annuity income. DOR data indicates that 4,390 taxpayers claimed this deduction in 2000 and deducted approximately $7.7 M in civil service annuity pay. From 1997 to 2000, this deduction declined by an average of about 1.9% per year. Thus, the 2004 deduction amount is estimated at about $7.1 M. According to the federal Office of Personnel Management, there are currently 24,927 federal retirees and 8,961 surviving spouses residing in Indiana. These individuals received civil service annuity payments totaling approximately $619.0 M during 2002. Assuming growth rates in annuity payments of 1.4% in 2003 (the established COLA) and 2.5% in 2004 (the average COLA since 2000), annuity payments are estimated to total about $633.4 M in 2004. Thus, if all civil service annuity income not claimed under the existing civil service annuity deduction (an estimated $626.2 M in 2004) is deducted from state taxable income in 2004, the corresponding revenue loss in FY 2005 is estimated to be approximately $21.3 M. Based on cost-of-living adjustments since 2000, this total could increase by as much as 2.5% annually thereafter.

Military Retirement Benefits: Under current statute, a taxpayer may deduct up to $2,000 in military service income. This deduction applies to all types of military service income, including retirement benefits and active and reserve duty pay. Data from the Department of State Revenue indicates that 34,476 taxpayers claimed the military service deduction (for military pay and retirement benefits) in tax year 2000. These taxpayers deducted approximately $67.6 M in adjusted gross income. It is estimated that about $43.3 M is attributable to military retirement payments. This deduction resulted in a revenue loss of about $2.3 M in FY 2001.The fiscal impact of the proposed military pension deduction is based on DOR tax data and census and pay rate data for military retirees in Indiana reported by the Department of Defense (DOD). Imputed totals for 2001 and 2002 based on the DOD census and pay rate data and actual totals for the military service deduction through 2000 suggest that the retirement portion of this deduction is increasing slightly by 0.84% annually. It is estimated that military retirement income in excess of that currently deductible could potentially total about $339.5 M in 2004. Thus, if all military pension income not already claimed under current deductions is deducted under the bill, the revenue loss is estimated to total about $11.5 M in FY 2005. The revenue loss is expected to increase thereafter by about 0.84% annually. Some military retirement income (i.e., disability retirement income) is currently not taxable under the federal Income Tax and, as a result, is already excluded from Indiana AGI. Recent DOD retirement pay data does not delineate between taxable and tax exempt military retirement payments to Indiana retirees. However, the proportion that is tax exempt is not expected to exceed 10% of total retirement payments. Thus, the revenue loss from the bill could be somewhat lower to the extent that DOD's military retirement payments to Indiana retirees reflect federally tax exempt retirement income.

Since the bill is effective beginning in tax year 2004, the majority of the fiscal impact would begin in FY 2005. There may be a slight reduction in estimated payments in the first six months of 2004 or FY 2004. Eighty-six percent of the revenue from the AGI Tax on individuals is deposited in the state General Fund, and 14% of this revenue is deposited in the Property Tax Replacement Fund.

Explanation of Local Expenditures:

Explanation of Local Revenues: Because the proposed deduction for civil service and military pension benefits would serve to decrease taxable income, counties imposing local option income taxes (CAGIT, COIT, and/or CEDIT) may, as a result, experience an indeterminable decrease in revenue from these taxes.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties with a local option income tax.

Information Sources: Department of State Revenue Income Tax data; Mike Dove, Department of Defense, Manpower Data Center, (831) 583-2400; Ed Callicott & Ellen Holmes, Federal Office of Personnel Management (OPM), (202) 606-1782, (202) 606-2242.

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